

EXTERNALITIES

When actions spillover to affect
3rd parties

EXTERNALITIES

- A sign of market failure

So far, we have only looked at situations where our decisions have had no influence on others

What happens if our actions do affect others, yet we don't take this into account?

Externalities

- **EXTERNALITIES** - Results of consumption/production decisions that affect 3rd parties (ie. Not those consuming/producing)

Externalities - could be positive (external benefit) or negative (external cost)

Why do externalities matter?

- Inefficient allocation of resources occur when externalities are present.

Examples:

- 1) Negative externality (pollution)
- 2) Positive externality (education)

Solving the Externalities Problem

- What can we do to solve this problem?

1) Property Rights - social arrangements that govern the use, ownership, and disposal of factors of production, goods and services - these are legally enforceable

2) Also, we could INTERNALIZE THE EXTERNALITY
This is done by adjusting the marginal cost/benefit of a good/service so efficient allocation is achieved.

2 ways to do this:

- 1) Corrective Tax
- 2) Corrective Subsidy
